The Changing Dynamics of the Mortgage Servicing Landscape

A review of the mortgage servicing market’s recent history and the way forward
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The State of Servicing

The objective of this paper is to describe the role that servicers play in the mortgage banking industry, provide a summary of the regulatory framework that applies to both bank and non-bank servicers, and provide perspective on two of the areas that have recently generated regulatory interest: mortgage servicing transfers and servicer net worth, capital, and liquidity requirements.

I. EXECUTIVE SUMMARY OF FINDINGS AND PERSPECTIVES

The mortgage servicing industry has experienced significant changes over the last decade. The 2008 financial crisis not only caused an increase in the number of delinquent borrowers that required assistance but also heightened the expectations that regulators, investors, and consumers have of mortgage servicers. Along with new regulatory standards at both the state and federal levels and enhancements to operational, capital, and liquidity requirements from investors, there have been recent calls for additional regulation.

In response to the increased scrutiny, servicers have bolstered processes, quality assurance, and customer-facing practices in order to remain compliant and those changes have manifested into rising servicing costs based on industry averages. The cost to service a performing loan has increased from $59 to $156 per loan per year from 2008 to 2013, while the non-performing cost to service has risen from $482 to $2,357 per loan per year over the same time period.1 While some servicers have attempted to mitigate these cost-to-service increases through technological innovation, many remain challenged by legacy platforms that require time-consuming and costly changes to accommodate the latest requirements and servicing standards. While the servicing business model (especially when servicing is retained) and origination business model are frequently viewed as having natural offsets, managing the economics of servicing has become more challenging for servicers.

During the financial crisis, mortgage servicing market share also began to shift with a reduction in concentration among the top servicers. Market share has not only undergone a general reduction in concentration, but there has also been a shift in servicing market share to non-banks as they continue to take advantage of opportunities to meet market demand. However, non-bank mortgage servicers in the top rankings are not a new phenomenon. In the late 1980s and early 1990s, non-depository mortgage bankers were major players in the servicing market. Today, while banks still hold the majority of the mortgage servicing assets in the country, the 5 largest non-bank servicers saw their market share grow by between 30 and 350 percent between 2001 and 2014.2 In our view, the primary drivers of non-bank servicing growth include:

- Servicing volume that has transferred from bank to non-bank servicers as a result of large servicers moving delinquent portfolios, portfolios being transferred from distressed entities, portfolios being transferred from institutions exiting the mortgage business, and GSE-mandated/GSE-arranged transfers;
- Banking institutions returning to a focus on their core banking/retail customer;
- Balancing of guarantee fees among Government-Sponsored Enterprise (GSE) sellers;
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• Emergence of firms that are structured to invest capital in Mortgage Servicing Rights (MSRs) and/or mortgage servicing companies, and;

• An increase in the number of banks that are using non-bank subservicers.

While banks and non-banks have differences in how they finance operations and whether they hold deposits, all mortgage entities are fundamentally originators and servicers subject to the same consumer-related regulatory requirements with differing prudential requirements. Regulation and scrutiny have increased across the board, and this paper will highlight two specific areas. First, as the market for MSRs has been active with the frequency and size of transfers increasing, regulators have been holding servicers to high expectations as it relates to the execution of servicing transfers to ensure borrower impact is minimized. Second, investors have imposed new capital, liquidity, and net worth requirements designed to mitigate servicer failures.

Change has become the new normal from a market composition and participant perspective. Regulators and guarantors with different oversight responsibilities have been enhancing prudential and other rules to protect borrowers and taxpayers. The impacts of these changes are not limited to servicers. Consumers are also impacted by servicing due to the interplay between servicing costs and upfront loan pricing. In a rising cost environment, the value of servicing/MSRs declines due to decreased profitability and one method that originators use to boost prices and preserve production margins is to increase rates and/or upfront origination costs.

In order for the mortgage servicing market to continue to function in an open, liquid, and efficient fashion, prudential standards should be harmonized across regulatory entities to maintain consistency while reducing the cost of compliance, and restrictions on transfers should be limited to allow servicers the ability to adapt their portfolios to manage their balance sheets and strategic objectives.


II. WHAT IS MORTGAGE SERVICING AND WHERE DOES IT TOUCH CONSUMERS?

MORTGAGE SERVICING MARKET
In today’s servicing market, mortgage servicers collect payments from borrowers, remit principal and interest to investors for securitized loans, remit property tax and insurance premiums from escrow funds, and perform collection, loss mitigation, and foreclosure activities with respect to delinquent borrowers. Fifty years ago, loan servicing was a back-office function often performed by the company that originated the loan to the borrower. But with the advent of the secondary mortgage market, the growth of the role of Fannie Mae and Freddie Mac, and the proliferation of different mortgage products particularly in the 1990s and early 2000s, the loan servicing operation became subject to more investor oversight and regulation.

SERVICER BUSINESS MODELS
The following three business models are the most prevalent in mortgage servicing today:

Bank Servicer:
• U.S. and state-chartered banks that serve as depository institutions, typically offering a full suite of consumer, investment, and financial products.

• Mortgage operations, both origination and servicing, are often within the consumer lending division.

• Historically, banks have retained mortgage servicing rights to maintain the customer relationship.

Non-Bank or Independent Mortgage Servicer:
• Two non-bank servicer models exist: the originator/servicer model and the servicer-only model.

• Within either model, some entities further specialize in specific functions, such as default management.

• As they are not banks, they do not hold customer deposits.

• Organizationally, non-bank mortgage companies can be publicly-traded, independent, or private equity or hedge fund-backed.
Subservicer:
- Subservicers are typically non-banks and they perform all servicing functions for the servicer of record (they do not own the mortgage servicing right).
- In this function, subservicers are third party vendors and are subject to third party vendor management protocols and guidelines.
- Fee arrangements are contractual where the subservicer is most often paid on a fee per loan basis (an IO strip is a less common form of contracts); therefore, subservicers are typically not MSR holders and do not hold traditional MSR-related risk.

**SERVicing AND IMPACTS TO THE CONSUMER BOTH DIRECT AND INDIRECT**

Loan servicing can impact consumers in two ways, directly and indirectly. First, consumers are directly impacted by the servicer’s ability to process their payments efficiently and manage their loan effectively, especially as it relates to escrow payments (taxes and insurance), loss mitigation procedures, and foreclosure/bankruptcy proceedings.

In a rising cost environment, the value of servicing declines due to decreased profitability and one method that originators can use to boost prices and preserve production margins is to increase rates; hence, the hidden but real impact of servicing costs on the consumer.

The second way in which consumers are impacted by servicing is an indirect and more subtle effect: servicing cost trends which affect upfront loan pricing and rate-setting (also see Figure 1: Illustration of Servicing Value Chain). The connection is best described by walking through the process. First, at the time of loan sale, originators record their gain on sale. Gain on sale is the difference between the net sales proceeds and the basis of the loans sold. One component of the gain on sale calculation is the MSR value which is determined through a modeling process that considers the future cash flows (both revenues and expenses) of the servicing right. Therefore, the projected cost to service a loan affects the MSR value, which in turn, affects the gain on sale for an originator. In a rising cost environment, the value of servicing declines due to decreased profitability and one method that originators

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**FIGURE 1: ILLUSTRATION OF SERVicing VALUE CHAIN**

<table>
<thead>
<tr>
<th>ORIGINATION</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>BORROWER</strong></td>
</tr>
<tr>
<td>Rate setting dependent on:</td>
</tr>
<tr>
<td>- Market rates</td>
</tr>
<tr>
<td>- Product type</td>
</tr>
<tr>
<td>- Borrower credit quality</td>
</tr>
<tr>
<td>- Borrower financials</td>
</tr>
<tr>
<td>- Originator or margin expectation</td>
</tr>
<tr>
<td><strong>ORIGINATOR/ SERVICER</strong></td>
</tr>
<tr>
<td>Gain on sale components:</td>
</tr>
<tr>
<td>- Loan sale proceeds</td>
</tr>
<tr>
<td>- Loan cost basis (including servicing value)</td>
</tr>
<tr>
<td>MSR created upon loan sale</td>
</tr>
<tr>
<td><strong>ORIGINATOR/ SERVICER</strong></td>
</tr>
<tr>
<td>Collects principal and 4% interest from borrower</td>
</tr>
<tr>
<td>Keeps 0.25% servicing fee as compensation for servicing (MSR)</td>
</tr>
<tr>
<td><strong>AGENCY/ GUARANTOR</strong></td>
</tr>
<tr>
<td>The GSEs also have the role of master servicer (see below)</td>
</tr>
<tr>
<td><strong>MASTER SERVICER/ GUARANTOR</strong></td>
</tr>
<tr>
<td>Keeps 0.25% guarantee fee as a compensation for guarantee</td>
</tr>
<tr>
<td><strong>INVESTOR</strong></td>
</tr>
<tr>
<td>Security &amp; Guarantee</td>
</tr>
<tr>
<td>MBS Purchase Price $</td>
</tr>
<tr>
<td><strong>INVESTOR</strong></td>
</tr>
<tr>
<td><strong>ORIGINATOR/ SERVICER</strong></td>
</tr>
<tr>
<td><strong>BORROWER</strong></td>
</tr>
<tr>
<td><strong>ORIGINATOR/ SERVICER</strong></td>
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<tr>
<td><strong>AGENCY/ GUARANTOR</strong></td>
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<tr>
<td><strong>MASTER SERVICER/ GUARANTOR</strong></td>
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<tr>
<td><strong>INVESTOR</strong></td>
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<tr>
<td><strong>ORIGINATOR/ SERVICER</strong></td>
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<tr>
<td><strong>BORROWER</strong></td>
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<td><strong>AGENCY/ GUARANTOR</strong></td>
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<tr>
<td><strong>MASTER SERVICER/ GUARANTOR</strong></td>
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<tr>
<td><strong>INVESTOR</strong></td>
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<tr>
<td><strong>ORIGINATOR/ SERVICER</strong></td>
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<tr>
<td><strong>BORROWER</strong></td>
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<td><strong>MASTER SERVICER/ GUARANTOR</strong></td>
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<td><strong>ORIGINATOR/ SERVICER</strong></td>
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<td><strong>MASTER SERVICER/ GUARANTOR</strong></td>
</tr>
<tr>
<td><strong>INVESTOR</strong></td>
</tr>
</tbody>
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can use to boost prices and preserve production margins is to increase rates; hence, the hidden but real impact of servicing costs on the consumer.

MORTGAGE SERVICING RIGHTS AS A DISTINCT ASSET
One feature that came along with the initiation of the mortgage-backed securities market was the concept of the Mortgage Servicing Right (MSR). The MSR is a separate and distinct asset from the loan and allows for the bifurcation of the loan cash flows between investors who take on the primary interest risk and servicing activities. This means that loan investors can reap the financial gains (and bear the credit risk), without the operational and regulatory requirements associated with performing the servicing functions for those loans. Furthermore, it is an asset that can be traded and transferred which provides valuable options for servicers to manage their balance sheet, provide liquidity, or manage risk.

MSRs also allow for specialization so that originators do not necessarily have to service loans and vice-versa, and servicers can further specialize on certain components of servicing functions or focus on specific populations of loans. Compensation for servicing loans is earned as a component of the note rate and is measured in basis points.

SERVICING REVENUES AND EXPENSES
Mortgage servicing profitability is driven by certain revenues and expenses. Revenues include servicing fees net of guarantee fees, ancillary fees, and float earnings from holding Principal & Interest (P&I) and Taxes & Insurance (T&I) payments between collection and remittance. Servicing fees are currently collected by servicers (MSR owners) as a component of the loan's note rate; therefore, servicers do not collect servicing fee revenue when borrowers are delinquent. For subservicers, compensation is typically earned through a per loan fee schedule which can be calculated as a dollar amount or in basis points. The minimum servicing fee for GSE loans is 25bp and for FHA/VA loans it is 19bp (GNMA II). The current compensation structure was established in the 1980s with the boom in the mortgage securitization market and has not been changed since.

Expenses include the direct cost-to-service, unreimbursed foreclosure and property expenses, allocated overhead, and the cost of funds (interest expense) for servicing advances. In addition, servicers can incur additional expenses on the back-end due to rep and warrants claims (origination reps and warrants pass to the current servicer), compensatory fees, and servicing deficiencies on FHA loans.

Note: The costs of servicing performing loans include both direct and overhead costs. The costs of servicing nonperforming loans include the base direct and corporate costs of servicing any loan, costs associated with managing a default, and unreimbursed foreclosure and real estate owned (REO) losses. Though an expense for servicers, this chart does not include interest expenses.

With additional regulatory, compliance, and operational expenditures, the industry’s average cost-to-service has steadily increased since 2008 as seen in Figure 2. The Housing Finance Policy Center also conducted a study which found that the overall cost-to-service for performing and non-performing loans have increased by 264% and 489% respectively since 2008.

MANAGING VOLATILITY
Managing volatility is an important issue for owners of servicing rights and an important consideration for companies thinking of retaining MSRs. From a business volatility perspective, servicers can leverage origination capabilities to serve as a ‘natural business hedge’: when rates decline and MSRs lose value, acquire and recapture loans through increased purchase/refinance volume. Another option for servicers is to sell portions of their servicing portfolio to reduce the size of the asset being managed.

Market risk and earnings volatility are also a major consideration as MSRs are typically an on-balance sheet asset at fair value; therefore, servicers often use derivatives, TBAs, and other instruments to attempt to “hedge out” earnings volatility. Unfortunately, hedging MSRs effectively is very challenging because the asset itself is not traded on an observable market and many servicers determine the fair value of their MSR using a model.

III. HOW IS THE MORTGAGE SERVICING INDUSTRY REGULATED TODAY?

The existing mortgage servicing regulatory and oversight framework is complex. Each mortgage servicer, bank or non-bank, is subject to supervision, oversight, and regulation by a number of regulatory entities.

The table below illustrates the existing supervisory and oversight framework.

<table>
<thead>
<tr>
<th>MORTGAGE SERVICER TYPE</th>
<th>CFPB</th>
<th>STATE INVESTOR</th>
<th>BANK REGULATORS (FDIC, FEDERAL RESERVE, OCC)</th>
<th>FHFA, GSEs, Ginnie Mae and Investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-banks</td>
<td>X</td>
<td>X</td>
<td>N/A</td>
<td>X^a</td>
</tr>
<tr>
<td>National banks and Federal Savings Assoc.</td>
<td>X^a</td>
<td>N/A</td>
<td>X</td>
<td>X^a</td>
</tr>
<tr>
<td>State-chartered banks (Fed members)</td>
<td>X^a</td>
<td>X</td>
<td>FDIC, Federal Reserve</td>
<td>X^a</td>
</tr>
<tr>
<td>State-chartered banks (not Fed members)</td>
<td>X^a</td>
<td>X</td>
<td>FDIC</td>
<td>X^a</td>
</tr>
</tbody>
</table>

a. The CFPB directly supervises banks that have more than $10 billion in assets.
b. Servicers servicing on behalf of the GSEs or investors are subject to GSE and investor oversight and requirements.
c. The FDIC also acts as receiver for all failed FDIC-insured depository institutions.

FIGURE 3: SUPERVISORY AND OVERSIGHT FRAMEWORK FOR SERVICERS

REGULATORY / OVERSIGHT ENTITIES

CFPB

In response to the financial crisis, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act, which established the Bureau of Consumer Financial Protection (CFPB) as a new regulatory entity. The CFPB inherited consumer financial protection laws and regulations from other federal agencies and also was granted authority to prohibit “unfair, deceptive or abusive acts or practices” (UDAAP) in connection with the offering of consumer financial products and services, including originating and servicing mortgages. The CFPB was granted direct supervisory authority of all banks with more than $10 billion in assets and over all non-banks, regardless of size, engaged in residential mortgage markets.

Soon after its establishment, the CFPB made mortgage servicing a priority. The CFPB observed that consumers have no power to select the servicers for their loans, but they are directly impacted by how servicers perform. The mortgage servicing activities now subject to CFPB specific oversight, in addition to wide-ranging UDAAP jurisdiction, include nine different areas: periodic statements; interest rate adjustment notices; prompt payment crediting and payoff payments; force-placed insurance; error resolution and information requests; general servicing policies, procedures and requirements; early intervention with delinquent borrowers; continuity of contact with delinquent borrowers; and loss mitigation procedures. The CFPB has also focused on the risk of consumers being harmed during the transferring of loan servicing, as transfers can be initiated without any input from the consumer.5

**FIGURE 4: SUMMARY OF CFPB’S MORTGAGE SERVICING RELATED GUIDANCE**

<table>
<thead>
<tr>
<th>CFPB RELEASE</th>
<th>SUMMARY OF ACTION / REQUIREMENTS</th>
</tr>
</thead>
</table>
| CFPB Examination Procedures and Non-bank Supervision Program | • Published Mortgage Servicing Examination Procedures in 2011 and revised them in 2012 to serve as the field guide for examiners  
• Launched federal non-bank supervision program in 2012 |

| CFPB Servicing Standards | • In 2014, made changes to Real Estate Settlement Procedures Act (Regulation X) and the Truth in Lending Act (Regulation Z)  
• Issued Bulletin on the application of the new rules to servicing transfers* (addressed in a subsequent section of this whitepaper)  
• In December 2014, amendments were proposed to ensure that homeowners and struggling borrowers are treated fairly by mortgage servicersb |

| CFPB and UDAAP | • Utilized Supervisory Highlights to identify mortgage servicing practices that could be considered UDAAP, including possible unfair or deceptive acts in connection servicing transfers, payment processing, loss mitigation programs, and treatment of military personnelc |

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**State-Level Consumer Protection**

The Conference of State Bank Supervisors (CSBS) is a nationwide organization of banking regulators from all 50 states, and other U.S. jurisdictions. The mission of the CSBS is to support the leadership role of state banking supervisors, represent the interests of state supervisors at the federal level, and optimize the authority of individual states in their oversight over supervised entities.6 State regulators implement their authority in varying ways, including regulation, licensing requirements, and examinations. Enforcement of state laws around foreclosures and bankruptcy also falls into the purview of state regulators. States have increasingly added new consumer protections to supplement federal consumer protection laws and regulations. Some examples of this include:

**California:** State lawmakers adopted the CA Homeowners’ Bill of Rights, which largely mirrors the terms of the NMS but applies to all mortgage servicers’ loans in the state.

**New York:** The New York Department of Financial Services (NYDFS) issued emergency regulations amending its Business Conduct Regulations as it pertains to mortgage servicing.

**Massachusetts:** The state enacted new requirements to prevent unnecessary and unlawful foreclosures.

**Washington and Illinois:** Enacted and implemented their own consumer protection rules, each with its own unique requirements.

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In addition to consumer protections, the CSBS has begun to look at risk management holistically and has proposed new prudential standards for non-bank servicers as part of ensuring that an “appropriate regulatory framework [exists] to instill market confidence and ensure consumer protection.”7 This increase in the level of state-level consumer protections affects both bank and non-bank mortgage servicers in that their compliance management systems (CMS) must be designed to efficiently manage compliance with applicable state and federal consumer protection laws and regulations.

**Other Federal Regulators — Federal Reserve, OCC, and FDIC**

The Federal Reserve, OCC, and FDIC each provide regulatory and supervisory oversight for banking institutions in addition to special roles that each play in the financial system. Aside from overseeing banks, the Federal Reserve conducts the nation’s monetary policy and provides financial services to the banking industry, the government, and foreign institutions; the OCC charters banks and savings institutions; and the FDIC insures deposits. Through its third party vendor management protocols, the OCC also has indirect oversight for subservicers who service on behalf of a bank.

The agencies routinely interact and coordinate with one another on specific policy initiatives, and also coordinate with other agencies, such as the CFPB or Department of Justice, on more targeted matters. Their primary objectives...

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6 “What is CSBS?” [CSBS.org](http://www.csbs.org)

related to their oversight responsibilities include ensuring the safety and soundness of the overall financial system by monitoring the financial and operational health of banking institutions, mitigating and containing the systemic risk within the financial system and markets, and ensuring compliance with applicable laws and regulations.

**Investor/Guarantor**

The GSEs, Ginnie Mae, and Private Label investors add an additional layer of oversight over seller/servicers in two ways: Seller/Servicer Guides (or Pooling and Servicing Agreements (PSAs) for private label) and requirements for capital, net worth, and liquidity. The latter will be discussed in the Capital & Liquidity section.

The GSEs perform periodic on-site and extensive reviews to evaluate the servicer’s financial and operational risks, including assessments of effectiveness of controls and compliance with the GSE’s seller and servicer guides. Failure of a mortgage servicer to meet the servicing guide standards instituted by the GSEs can result in a corrective action plans, sanctions, or compensatory fees.

- Fannie Mae’s STAR “program evaluates servicers across key operational and performance areas relative to their peers, and acknowledges their achievement through STAR designations.”

- “The Freddie Mac Servicer Success Scorecard provides [servicers] with comprehensive measurements in multiple categories, and assesses [servicers’] results in the defined categories each month.”

- Ginnie Mae compares issuers’ operational strength and skill in managing delinquent loans with those of their peers. They also have started a spotlight servicer program to monitor rapidly expanding firms.

**Trustees/Rating Agencies**

Private MBS investors utilize contractual provisions within the PSAs to ensure proper servicing practices are in place to remain compliant and protect against credit losses. The PSAs document expectations of servicers regarding the transfer and delivery of loans, servicing of loans, and distribution to certificate holders and investors. They also allow trustees, working on behalf of the investors, to impose corrective actions or force the transfer of servicing if the servicer fails or is at risk of failing to perform. In addition, rating agencies provide another layer of oversight for servicers by performing annual servicer performance assessments and providing grades specific to RMBS servicing.

A harmonized or aligned set of rules that can be enforced at both the federal and state levels would ensure that the rights of consumers and investors are protected and reduce the complexity of the operating model that is in place today at both small and large servicers.

**SERVICING REGULATION: PERSPECTIVES ON NEXT STEPS**

The focus that regulators have placed on mortgage servicers has made compliance one of the key criteria for success. As a result, a level of scale and fixed cost is required in the form of a compliance department to manage adherence to compliance requirements. Recent regulatory requirement enhancements have resulted in significant increases to servicing costs due to their complexity and their evolving nature, which may be directly or indirectly passed on to the consumer through increases in interest rates or fees.

While new regulation has increased transparency and protects the rights of the consumer, there is also an opportunity to rationalize certain federal and state requirements in order to facilitate compliance and reduce cost. A harmonized or aligned set of rules that can be enforced at both the federal and state levels would ensure that the rights of consumers and investors are protected and reduce the complexity of the operating model that is in place today at both small and large servicers.

**IV. MORTGAGE SERVICING: A CHANGING LANDSCAPE**

While the emergence of non-banks in the current servicing landscape has caught the attention of regulators, their presence is hardly new. Non-banks have historically augmented the marketplace where banking institutions have left openings. While banks and thrifts were the original mortgage lenders using customer deposits to fund loans, non-banks first came to prominence as independent lenders following the birth of the modern day securitization market. In the 1980s, with the secondary market providing ample liquidity to originate loans, and the consolidation and elimination of numerous thrifts during the Savings and Loan Crisis, non-banks helped provide additional lending conduits for borrowers seeking mortgages. In the most recent years, non-banks have also adapted their servicing business models to the changing economic environment by either transitioning from a seller-only to a seller/servicer model or by focusing on acquiring specialty and delinquent servicing.

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8 Fannie Mae STAR program website. https://www.fanniemae.com/singlefamily/star


Figure 5: Top 20 Mortgage Servicers from 1990-2014: Allocation by Bank/Non-Bank (Billions $)

**ROLE OF NON-BANKS DURING THE FINANCIAL CRISIS**

During the financial crisis, delinquent loan volumes significantly increased, and existing servicers struggled to manage the volume. Servicing these loans required not only an increase in staffing levels and investments in processes and technology to accommodate the volume, but also a new degree of specialization to efficiently manage loss mitigation efforts, foreclosure, and bankruptcy activities as well as the requirements of newly created programs aimed to assist borrowers such as Making Home Affordable (MHA).\(^\text{10}\)

In response to the demands, specialty, high-touch, and component non-bank servicers who focused on defaulted loans, specific products, or geographic regions where they developed expertise were active in offering their services to the largest servicers. These non-bank servicers had different organizational structures and were able to focus more specifically on borrowers with outstanding payments. For banks looking to sell servicing or contract with a subservicer, these specialty servicers were an attractive outlet.

**RETURN OF NON-BANKS AS MAJOR PLAYERS**

Since the financial crisis, the percentage of loans serviced by non-banks (among the top 20 servicers) has steadily increased from 12% to 31%. While banking institutions continue to originate and service the majority of loans (as of September 2014, FHFA-OIG\(^\text{11}\) reported that non-bank servicers service 14% of the $10T outstanding principal (up from 6% at the end of 2011\(^\text{12}\)), non-bank servicers accounted for half of the top 10 servicer positions.

Figure 6: Top 20 Servicers, Bank/Non-Bank Split

**Non-banks Recapturing Market Share in Private-label Securities Servicing**

While their share of the overall servicing market is only 14%, non-bank servicers currently own the majority of private label security (PLS) servicing with approximately 74% market share by loan count. Non-bank servicers held the majority of market share in 2006 and 2007; however, due to bank acquisitions/takeovers of non-banks during the financial crisis (especially those focused on private label servicing), banks assumed the majority position again until 2013. While non-banks have consolidated legacy PLS servicing portfolios to add to their servicing books, there has been little opportunity to grow significantly as PLS issuances have been limited since 2008, and the non-agency securitization market remains almost non-existent.

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Mixed Views: Connection Between Basel III and MSR Transfer Volumes

Basel III, the regulatory capital requirements standard, has specific requirements related to MSRs, and in the final rule, those requirements apply to all banks regardless of size. While the Basel III rules impact some banks more than others depending on their respective MSR asset sizes and capital positions, the Basel III rules are more stringent for all banks when compared to the previous capital requirements. The final rule states that MSRs are limited to 10% of a bank’s common equity Tier 1 capital (CET1); any MSRs in excess of 10% are deducted from common equity and if not deducted are subject to a 100% risk-weight that increases to 250% in 2018.\footnote{US Basel III Regulatory Capital Regime and Market Risk Final Rule; https://www.pwc.com/en_US/us/financial-services/regulatory-services/publications/assets/pwc-basel-iii-capital-market-risk-final-rule.pdf}

Industry observers have noted that there are banks large and small that have MSR positions above or near the 10 percent threshold which can be observed through company disclosures. One report released by Moody’s in January 2015 found that the impact of Basel III should be minor on a go-forward basis for the top 6 banks; however, that sample size was limited to only the largest 6 banks.

Ultimately, the impact of Basel III must be analyzed on a bank-by-bank basis with full consideration of the facts and circumstances of each bank’s MSR and capital positions. All banks are aware of Basel III and are managing their business while considering the rules: some banks may have room to grow their MSR investment, while others may already be constrained. However, what can be said is that the Basel III is an important consideration among banks when deciding on investments they will make in the mortgage origination and servicing business.


RE-EMERGENCE OF SMALL MORTGAGE LENDERS

A notable subset of the re-emergent non-banks are the smaller mortgage companies that have made substantial market share gains in recent years, particularly in origination volume. Since 2009 Q4, non-bank mortgage lenders have increased their origination market share among the top 50 lenders from 12% to 41% in 2014 Q3.\footnote{14 Calculated using National Mortgage News Quarterly Data Reports. Independent mortgage lenders defined as privately owned and not publicly traded.} Several factors have contributed to the rise of the smaller mortgage lender including FHFA’s guarantee fee parity initiative, warehouse credit becoming more widely available, and large depositary banks limiting their credit box and tightening underwriting standards due to caution about loan repurchases and new regulations.

One of the factors listed above is GSE guarantee fee parity, particular to parity across lenders and products. Historically, the GSEs offered lower guarantee fees to their large volume sellers as a financial incentive and competitive advantage. As a result, the highest volume sellers employed the “aggregator model” by purchasing mortgages originated by smaller lenders and selling them to the GSEs. Small lenders sold their originated loans servicing released and had limited options to retain the customer through the servicing relationship due to the attractive gain on sale opportunity. Despite losing the customer, this model was attractive because the aggregators could pass on a portion of their guarantee fee discount and still maintain margins.\footnote{15 Recent Trends in the Enterprises’ Purchases of Mortgages from Smaller Lenders and Non-bank Mortgage Companies, FHFA, Office of Inspector General. http://origin.www.fhfaoig.gov/Content/Files/EVL-2014-010_0.pdf}

In 2014, FHFA released a report detailing the impacts of guarantee fee changes in which it states that “pricing differences between small sellers and large sellers have been substantially reduced.”\footnote{16 http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/GFeeReport1120914.pdf} The chart below further shows how acquisition volume market share for Medium, Small, and Extra-Small lenders has grown over the same span that guarantee fees were normalized across lenders.

FIGURE 7: TOP 5 NON-AGENCY SERVICERS, BANK/NON-BANK SPLIT

% by loan count

<table>
<thead>
<tr>
<th>Year</th>
<th>Non-bank — Top 5</th>
<th>Bank — Top 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td>2004</td>
<td>20</td>
<td>80</td>
</tr>
<tr>
<td>2005</td>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>2006</td>
<td>60</td>
<td>40</td>
</tr>
<tr>
<td>2007</td>
<td>80</td>
<td>20</td>
</tr>
<tr>
<td>2008</td>
<td>100</td>
<td>0</td>
</tr>
<tr>
<td>2009</td>
<td>0</td>
<td>100</td>
</tr>
<tr>
<td>2010</td>
<td>20</td>
<td>80</td>
</tr>
<tr>
<td>2011</td>
<td>40</td>
<td>60</td>
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<tr>
<td>2012</td>
<td>60</td>
<td>40</td>
</tr>
<tr>
<td>2013</td>
<td>80</td>
<td>20</td>
</tr>
<tr>
<td>2014</td>
<td>100</td>
<td>0</td>
</tr>
</tbody>
</table>
Guarantee fee parity and the other factors listed above have allowed smaller lenders to have direct relationships with the GSEs and retain servicing if desired. As a result, lenders are more readily able to follow the historically traditional organic growth path from a pure servicing-released model, to a servicing-retained model with subservicing, and finally to an end-to-end origination to servicing model, to a servicing-retained model with subservicing, and finally to an end-to-end origination to servicing model in the hopes of capitalizing on the customer relationship, the servicing cash flows, and the refinance or next purchase opportunity. Overall, this is a positive trend as the number of seasoned independent mortgage lenders has grown and consumers have more choices when selecting a mortgage lender.

**V. TRANSFER AND CAPITAL/LIQUIDITY REQUIREMENTS: TWO RECENT AREAS IN FOCUS**

**SERVICING TRANSFERS**

Servicing transfers have been in focus for regulators due to the increase in frequency and size of bulk transfers, the operational complexity of transferring loan servicing, and the potential impact to borrowers and investors. For borrowers, regulators have been monitoring transfers of servicing to prevent them from affecting service levels, payment processing, or loss mitigation processes. Investors also have a vested interest in timely collection of principal and interest payments and effective loss mitigation; therefore, investors reserve the right not only to approve or deny transfer requests, but also to mandate servicing transfers as the GSEs did in 2006-2007. Since then, the GSEs have also entered into certain MSR purchase agreements, both bulk and flow, to facilitate even greater control over their risk exposure. Outside of the GSEs, there has been significant willingness by private capital to invest in servicing over the last several years. In addition, as the GSEs focus on their FHFA scorecard goals to reduce their footprint, servicing transfers will again be necessary to transfer servicing ownership to private capital.

The contracts under which portfolios transfer can take on multiple forms: including transfers of whole loans (loan and servicing sold together), MSR only (servicing rights are transferred but the loan P&I remains), or subservicing contracts to perform servicing functions on behalf of another servicer (the MSR remains with the transferor but the servicing operations moves to the subservicer). In some cases, transfers may be large scale “bulk” transactions or smaller “flow” arrangements where loans may continually transfer under an on-going agreement based on trigger criteria.

**Bulk Transfers**

Bulk transfers are characterized as identified loan populations that are transferred simultaneously, or in close sequence, as part of an agreement between servicers to sell MSRs or outsource servicing functions. Due to the nature of transferring a large volume of loans within a short window, bulk transfers require careful planning and preparation. These transactions are broken into several key phases as noted in the diagram.

**Flow Transfers**

Flow transfers involve servicing moving from one servicer to another over a period of time, based on a set of trigger criteria. Flow transfers are typically used in one of two ways: first, by small originators that do not currently have the infrastructure to service loans in house for more than a couple of months after the loan was originated and second, by servicers that focus on performing loans and transfer the servicing of delinquent accounts to a specialty servicer.

### Figure 8: GSE Acquisition Volumes by Seller Rank/Size*

<table>
<thead>
<tr>
<th>Year</th>
<th>XL 1–5</th>
<th>L 6–15</th>
<th>M 16–25</th>
<th>S 26–100</th>
<th>XS 101+</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>60%</td>
<td>18%</td>
<td>4%</td>
<td>6%</td>
<td>8%</td>
</tr>
<tr>
<td>2011</td>
<td>58%</td>
<td>22%</td>
<td>4%</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>2012</td>
<td>49%</td>
<td>19%</td>
<td>6%</td>
<td>10%</td>
<td>16%</td>
</tr>
<tr>
<td>2013</td>
<td>49%</td>
<td>17%</td>
<td>6%</td>
<td>10%</td>
<td>19%</td>
</tr>
<tr>
<td>Change from 2012</td>
<td>0%</td>
<td>-2%</td>
<td>0%</td>
<td>0%</td>
<td>3%</td>
</tr>
</tbody>
</table>

* Based on study population for standard loans for 2010–2013. 


### Figure 9: Servicing Transfer Process — Key Steps

<table>
<thead>
<tr>
<th>Phase</th>
<th>Description</th>
<th>Key Steps</th>
</tr>
</thead>
</table>
| Pre-Deal | The seller marks its portfolio for MSR sale or subservicing transfer. | • Due Diligence  
• Operational Model Compatibility  
• Determine When to Transfer  
• Define Transfer Portfolio |
| Pre-Transfer | The true planning phase between the seller and buyer (or subservicer). | • Resourcing & Capacity  
• Investor & Regulatory Consents  
• Customer Considerations  
• Document Activities/PSA Review |
| Transfer | The migration of data to the buyer’s loan servicing platform. Servicing responsibility is transferred to the buyer. | • Execute Organizational Strategy  
• Execute Communication Strategy  
• Real-time Remediation of Data  
• Real-time Remediation of Docs |
| Post-Transfer | While the buyer is responsible for servicing activities, the seller should be aware of ongoing responsibility. | • Training Documents  
• Payment Forwarding  
• Managing Repurchases  
• Servicing Advance Reconciliation |
Managing the Complexity
Due to the complexity of transfers and the potential for borrower/investor impacts, regulators, GSEs, and even FHFA have taken notice of servicing transfers with their recent amendments, pronouncements, and oversight measures.

The transfer process is not a simple one and requires proper oversight and management to ensure compliance is maintained and issues are resolved timely. Each transfer involves borrower communication from both parties, detailed transfer instructions, and the transfer of data, documents, images, invoices, and borrower funds. Furthermore, the complexity increases significantly when the portfolio contains delinquent loans, especially those with in-flight loss mitigation actions which should be continued by the new servicer seamlessly.

Servicers have become more adept at managing these complex transactions. Many have created “centers of excellence” within their organizations, as transfer execution (pre-due diligence, data quality and integrity checks, in-flight loss mitigation transfers) has become a core competency for many current servicers.

CURRENT REGULATORY LANDSCAPE FOR TRANSFERS
The oversight environment for servicing transfers was previously limited, with RESPA guidelines for hello/goodbye letters and the GSEs requiring their approval before agency loans went through a transfer. In 2014, the CFPB has stepped into a larger role for the industry through its pronouncements as well as its amendments to RESPA. Clarifying guidance has been released by the CFPB and the GSEs have also put more rigor around their approval process at the guidance of FHFA. The following chart summarizes the releases of supervisory guidance:

The guiding principle for servicing regulation should be to achieve a balance between protecting the consumer and keeping the market for MSRs as liquid as possible to ensure that pricing spreads do not widen artificially and increase cost-to-transfer.

Keeping the Transfer Market Open
The result of the CFPB and other regulators being increasingly active in the servicing transfer space speaks to the importance they place on protecting the borrower, who does not have a voice in the transfer process. These prescriptive measures are in place to facilitate and normalize the transfer execution process and provide comfort to all parties that servicing transfers are an enabler for the market and not a detractor. Therefore, principles-based regulation to ensure orderly servicing transfers has been welcomed due to the unique nature and complexity of any given transfer/sale agreement and transfer execution. The guiding principle for servicing regulation should be to achieve a balance between protecting the consumer and keeping the market for MSRs as liquid as possible to ensure that pricing spreads do not widen artificially and increase cost-to-transfer.

CAPITAL & LIQUIDITY: A CLOSER LOOK AT THE NEEDS OF A MORTGAGE LENDER/SERVICER
While the industry works to adapt to the operational and procedural changes that have come with new requirements for servicing transfers, the discussion around capital requirements is becoming more involved, especially as it concerns non-bank servicers.
Capital and Liquidity Background

One of the reasons the recent financial crisis was so severe was that the banking sectors of many countries had built up excessive on and off-balance sheet leverage accompanied with a gradual erosion of the size and quality of the capital base. As a result of these events, the Basel Committee on Banking Supervision enacted Basel III, the most significant set of capital requirements to date.

As noted earlier, banks are depository institutions and are already subject to prudential standards which govern the capital requirements for those entities. On the other hand, non-banks have not been subject to those same prudential requirements to date; however, several proposals have been developed which would enhance capital, liquidity, and net worth requirements for non-bank servicers.

### Sources of Liquidity for Lenders/Servicers

Banks and non-banks are exposed to liquidity risk due to the highly variable cash requirements needed to support the servicing business. In the traditional banking model, liquidity is derived from the customer deposit base along with other capital markets and financing sources. Since non-banks do not have a deposit base to draw upon, they must generate or raise capital from other avenues. See the following page for the various sources of liquidity for lenders and servicers.

### Capital and Liquidity Background

As noted earlier, banks are depository institutions and are already subject to prudential standards which govern the capital requirements for those entities. On the other hand, non-banks have not been subject to those same prudential requirements to date; however, several proposals have been developed which would enhance capital, liquidity, and net worth requirements for non-bank servicers.

### Figure 11: Summary of Capital, Liquidity, and Net Worth Requirements

<table>
<thead>
<tr>
<th>REQUIREMENT</th>
<th>ENFORCING ENTITY</th>
<th>REQUIREMENT DESCRIPTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum Net Worth</td>
<td>FHFA (GSEs) CSBS (proposed)</td>
<td>Base of $2.5 million plus 25 basis points of unpaid principal balance (UPB) for total loans serviced</td>
</tr>
<tr>
<td></td>
<td>Ginnie Mae</td>
<td>Requires minimum net worth of $2.5 million, plus 35 bp (previously 20 bp) of unpaid principal balance total loans serviced for Ginnie Mae (effective 1/1/15 for new issuers, 12/31/15 for existing issuers)</td>
</tr>
<tr>
<td>Capital Requirements</td>
<td>Ginnie Mae</td>
<td>Banks: Meet the regulatory definition of “well-capitalized” Non-banks: Lender Adjusted Net Worth/Total Assets ratio of 6%, or equivalent</td>
</tr>
<tr>
<td></td>
<td>FHFA (GSEs)</td>
<td>Banks: Continue to comply with regulatory standards Non-banks: Tangible Net Worth/Total Assets of 6%</td>
</tr>
<tr>
<td></td>
<td>Fed OCC FDIC</td>
<td>Basel III capital framework</td>
</tr>
<tr>
<td>Liquidity Requirements</td>
<td>Ginnie Mae</td>
<td>Liquid assets of either $1 million or 0.10% of outstanding single-family securities, whichever is greater (previously 20% of net worth) (effective 1/1/15 for new issuers, 12/31/15 for existing issuers)</td>
</tr>
<tr>
<td></td>
<td>FHFA (GSEs)</td>
<td>Banks: Continue to comply with regulatory standards Non-banks (would be a new requirement):</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• 3.5 basis points of total Agency servicing (Fannie Mae, Freddie Mac, Ginnie Mae) plus,</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Incremental 200 basis points of total non-performing Agency servicing in excess of 6% of the total Agency servicing UPB</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Allowable assets for liquidity may include the following:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>+ Cash and Cash Equivalents (Unrestricted)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>+ Available for Sale (AFS) or Held for Trading (HFT) Investment Grade Securities: Agency MBS, Obligations of GSEs, US Treasury Obligations</td>
</tr>
<tr>
<td></td>
<td></td>
<td>+ Unused/available portion of committed servicing advance lines (a quarterly CFO certification of this information will be required at this time)</td>
</tr>
<tr>
<td></td>
<td>CSBS (proposed)</td>
<td>3.5 basis points of all serviced UPB</td>
</tr>
</tbody>
</table>

---

A. **Multiple Sources:** FHFA Eligibility Requirements for Seller/Servicers (linked to Freddie Mac; however, Fannie and Freddie have the same requirements as set by FHFA): [http://www.freddiemac.com/singlefamily/guide/bulletins/pdf/bll1508.pdf](http://www.freddiemac.com/singlefamily/guide/bulletins/pdf/bll1508.pdf)


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**THE CHANGING DYNAMICS OF THE MORTGAGE SERVICING LANDSCAPE**

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Despite non-banks having multiple potential sources for funding, they still face higher liquidity risk and funding costs than banks due to borrowings limits from warehouse lines and advance facilities, delinquency shocks, as well as limitations imposed by existing lenders. For all institutions, liquidity impacts are harder to manage for delinquent portfolios as operating costs and servicing advances are higher.

Capital & Liquidity Requirements / Regulations

In their respective Seller/Servicer guides, the Agencies (Fannie Mae, Freddie Mac, and Ginnie Mae) have all defined specific net worth, capital, and liquidity requirements in order to qualify for and maintain Seller/Servicer status. While some of these requirements overlap, there are subtle differences between each of the Agencies, as highlighted below.

The FHFA proposed requirements are minimum financial eligibility requirements and are based on “an extensive review of financial risks that the Enterprises face from doing business with their Sellers and Servicers.”

Conceptual Frameworks for Monitoring Financial Risk at Non-Banks

Determining the best course of action depends on the stated objective. Prudential standards at depository institutions that require formalized stress testing and certain capital ratios are intended to protect customer’s deposits; and upon a total bank failure, protect the taxpayers since deposits are insured under the Federal Deposit Insurance Corporation (FDIC). These standards are also designed to preserve the overall stability of the U.S. financial system. On the other hand, Agency and investor requirements for seller/servicers serve to protect investors and guarantors from financial harm. Currently, markets are functioning with the GSEs and investors relying on contractual protections agreed to by the Agencies, investors, and servicers in the market.

The Conference of State Bank Supervisors (CSBS) has released a proposal for states to use in prescribing minimum capital ratios and other prudential standards for non-bank mortgage servicers. As noted in Figure 11, FHFA has recently finalized a new set of liquidity requirements for non-bank servicers (net worth and capital requirements are consistent with current guidelines). And Ginnie Mae has established new measures and standards for banks and non-banks including closer scrutiny of an issuer’s liquidity and sources of funding and more frequent and detailed MSR portfolio valuations. Ginnie Mae’s new requirements go into effect January 1, 2015 for new issuers and December 31, 2015 for existing issuers.

However, other interesting concepts exist to serve the need of providing financial oversight to non-bank originators and servicers and should be considered. One such concept is a set of measurements to assess or rate liquidity sufficiency at non-banks. Due to the nature of how non-banks finance their operations using a leveraged model, utilizing key metrics and factors for determining a servicer’s liquidity position that consider the sources of liquidity listed above for on-going monitoring may be more advantageous than attempting to apply stringent stress testing scenarios or capital ratios. While FHFA has taken an initial step towards this concept for non-bank GSE seller/servicers with the quarterly MBFRF (Mortgage Banking Financial Reporting Form) submission, it would be ideal to have the concept instituted uniformly across regulators/oversseers to ensure that a holistic view of non-bank institutions is captured.

VI. WHERE IS SERVICING HEADING?

The future success of the servicing market will depend on various drivers, many of which are already evident. Diversity in business models allows for healthy competition and pushes market dynamics to fill demands when certain market participants exit or reduce their positions. The challenges faced by the industry are also driving new entrants and growing companies to use disruptive methods to bring value to the consumer. Several business model strategies have emerged that provide indications of where certain servicers are heading: there is certainly no “one size fits all” approach to success.
Originators Adding Servicing Capabilities: Use Case for the Organic Growth Pattern

Another growth pattern is clearly emerging with several non-banks bringing their servicing in-house. In the shift towards the originate-to-retain model, these companies are shifting away from selling servicing-released or using subservicers and are opting to open and establish their in-house servicing operations. The fundamental benefit is the opportunity to take advantage of the natural hedge: when rates rise, MSR values increase due to lower prepayment rates which offsets lower revenue due to reduced production volumes. The other critical benefit is a long-term relationship with the borrower from end-to-end which provides the best opportunity to capitalize on refinance or next-purchase opportunities.

Servicers Adding Origination and Other Capabilities

Finally, another non-bank strategy emerging in today’s market is the emergence of full-service homeownership providers. These are non-bank servicers who are shifting their focus to a broader range of services (e.g. originations and real-estate listings) beyond their core competencies of traditional mortgage servicing in order to offer a truly end-to-end approach to the customer. Potential characteristics of this model may also include enhanced customer experience options, such as a white-glove approach for certain customer segments where a customer looking to move is offered real estate listing services to sell and to buy, and their new loan is pre-qualified and ready once the right property is acquired. This strategy goes beyond the loan as companies look to win a ‘customer for life,’ from property to property.

Doubling down on default servicing:

Specialty and component servicers

Known as “go-to” providers for default servicing, these specialty and component servicers acquire servicing or form contractual agreements with other major servicers to provide or augment specific functions within the servicing business. Due to the tighter credit requirements that have been in place for the last 5 years, stabilization of house prices, and improvement in the economy, delinquency levels have been on the decline, and default servicers who are not expanding their business model to other areas will need to adapt their operating model to the reduced capacity requirements.

Through these various models, some non-bank servicers have diversified their businesses to specialize in particular functions or geographies of servicing, while others have worked to launch a robust originations business to supply their growing servicing engines. While no one model has more merit than the other, each servicer must determine which go-forward strategy aligns with their long term goals and objectives.
VII. CONCLUSION

The market has seen tremendous change since the fallout of the 2008 crisis. Non-bank entities have increasingly become key players in the market once again, and their growth has captured the attention of all stakeholders. Their presence in the servicing market has provided willing MSR buyers to balance shifts in demand for holding MSRs among the largest servicers and has consequently helped to support the volatile demand driven from several recent refinance markets.

Capital and liquidity requirements are key components of the regulatory toolkit, and as an industry we must consider the diverse body of entities entering the market and their specific value and risk propositions to tailor those requirements. Furthermore, the standards need to be unified, harmonized, and agreed to across the enforcing entities to drive simplification without sacrificing the ability to manage risk.

For industry participants, it is critical that the flexibility exists to adapt business models and strategies when the markets dictate change. For servicers and originators, this means that the option to sell, retain, or transfer servicing is available as desired to manage their portfolio to meet financial expectations. If certain transactions are restricted or limited, this could lead to unexpected disruption in the industry, threaten current business models, and most importantly, negatively impact the quality of service and availability of credit for consumers.

The combination of rates at historic lows and refinance activity drying up has led industry participants to begin preparation for a rising rate environment in advance of significant rate movement. Change is in the air. Business models are being adapted and long-term strategies are being renewed. In order to allow participants to freely adapt to the changes they face, opportunities should be sought by regulators to align regulation across dimensions such as federal and state, agency and non-agency, and bank and non-bank. If the regulatory and supervisory frameworks continue to overlap, overall servicing costs will continue to rise and both consumers and industry participants will be negatively impacted in the short- and long-run.
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